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Recession out of Control

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Abstract

Current practice that ignores business cycles in forming short-term policy is delusive. This view is based on analysis depicting two concentric stock-flow cycles: one in production and real investment, the other in credit expansion and liquidation. The role of stocks -- real goods and facilities, financial assets and debt -- is emphasized. Private money holdings boosted to excess by bank credit, new forms of payment, and surplus savings from gains and tax cuts are largely responsible for the inflation and lead to speculative booms. Government monetary and fiscal policies, often perverse, have only limited effects in dealing with recessions.

The recessions of 1980-81 with continuing inflation have led to unprecedented confusion in economic theory and policy. This is most evident in current discussions of "savings." It now seems almost taken for granted that saving determines investment and will somehow be a cure for inflation. This erroneous reversal of theory depends in part upon supply-side magic and simplistic monetarism. But it is even more due to dominance of the mass media by the people who like the policy implications of those theories and want to do something for themselves by promoting more tax incentives for saving.

Mix with this the belief of a generation whose experience through the long postwar prosperity tells them that recessions can only be minor, that depression need never again be feared. That view--previously prevalent before the crash of 1929--leads to undue concentration on short-run considerations; it says, in effect, solve the immediate problems and the growth that is "normal" for the economy will take over. Both government and private financial problems are conceived in the same near-sighted perspectives. Overlooked is the fact that the short term does not merge into the long term, but into the intermediate term, which in peace time tends to be dominated by cyclical fluctuations in the private sector.

Combine this mix with the outcry of the government haters who think we can go back to a sounder economic condition based on old-time principles and thus turn the economy around to make everything right in the world. They chose the political route for accomplishing their goal and in victory are striving to enforce policies that could break the boom.

Perhaps we should be willing to have new ideas put to the test in the real world in order to determine their validity. The trouble is that none of us knows how disruptive such experimentation could be.

The Double Carrousel

In contrast to these views, I want to stress the basic and growing instability of the economy and to point out that the forces responsible for it are inherent in the private economy, not in the government accounts. To do this requires, of course, some theory of business cycles. That will be the focus of most of what follows.

Chart 1 portrays the two basic components of business cycles: first, the inner circle shows the real cycle in production, investment, real income and consumption, and in the stocks of goods and facilities that are created by and used up in those processes; and second, the outer circle is credit cycle which builds or runs off stocks of money and other financial assets by expansion and liquidation of debt. Both cycles are governed by similar stock-flow relationships and the link between them is the price system. I call these dominant central parts of this diagram the Double Carrousel.

The lines of influence exerted by the stocks and flows are always clockwise, but they work both for expansion and contraction. Starting at the lower left, if there is an increase in the current-dollar or real gross national product (GNP), it calls for an increase in the corresponding stock at the top of each circle; this in turn requires increased investment at the lower right; and this in turn expands the GNP with multiplier effects; so the movement cumulates. Conversely, a decline in GNP

makes stocks excessive, calls for a reduction in investment, and curtails the GNP still more via the multiplier, with cumulative effects on the downside.

If the stocks at the top of the chart are omitted, and the flows are short-cut from GNP to investment, the result is a simple accelerator-multiplier model of the kind described in the renowned article by Samuelson. Such models have been tried in many econometric models without satisfactory results; they do not adequately describe the economy. The stocks are necessary both in defining the need for investment and in facilitating the flows that create them, and their positions govern the turning points.

If all prices were stable, the two cycles would be the same. Actually, there is an interplay between them that tends to carry the economy to extremes. The price linkages are portrayed as helical springs at each of the key points in the cycles. Their flexibility permits contraction or separation, unevenly and with skewness. When one cycle accelerates, it pulls the other along, and when the other in turn speeds up, it puts new life in the first. Conversely, when one cycle slows, it puts a drag on the other.

In the boom there is increased willingness to hold stocks and to incur debt for this purpose, and high activity seems for a while to justify both, but only to the point where excesses are revealed and cutbacks must begin. At that point liquidation begins and prices may be sacrificed in special sales or rebate deals as stocks are dumped. In the trough, the liquidation of stocks also overcarries, so shortages may be encountered.

Whenever the outer circle moves much faster than the inner, the result is inflation. Product prices include a large wage component whose impact is mostly lagged. Wage contracts tend to keep inflation going, not to initiate it.

For the price linkage at the point of investment, interest rates are shown. Investment goods have prices that are not determined by interest rates, of course, but they are products, too, so at this point it is appropriate to stress interest rates as an important element in deciding whether to undertake real investment or divert funds into other assets, either pre-existing real assets or financial assets.

Business cycles are not immutable. They are modified by extraneous events, and in these, government plays a big role. I have portrayed its fiscal operations as standing between the two cyclical flows, with expenditures and taxes adding to and withdrawing from both. Throughout the period following World War II, prosperity has been supported and prolonged, not only by government in recessions, but by international disturbances and by economic growth all around the globe. This prosperity now seems to be reaching its end and government intervention is being curtailed.

Currently we tend to overlook the limitations on government powers; the range of adjustment in its programs is wider now than it was but is still not large relative to GNP. If there should be a major cyclical decline, like that of the 1930's, there is nothing in the powers of government to reverse a concerted movement in the private economy.

The monetary authority is shown at the top of the chart, its policies serving to expand or restrict the stock of monetary assets. There

are some tendencies, especially among monetarists, both to overrate its control powers and to overrate the influence of the stock of monetary assets on the real flows, that is, on business activity and employment rather than just on prices. These points will be explained more fully later.

I believe this version of the Double Carrousel is consistent both with Keynes' General Theory and with acceptable monetarism, although not with some interpretations of those theories. Keynes did little with the real cycle, presumably because he did not have the necessary data. Many monetarists ignore the real cycle completely and, in assuming that money can be controlled, ignore the cyclical aspects of the credit cycle as well. The Double Carrousel to some extent remedies these deficiencies in the way it integrates the two theories.

Relationships and Developments in the Real Cycle

There are several aspects of the real cycle that should be understood in ways different from that shown on Chart 1. The real cycle is made up of an aggregation of subcycles which vary in timing and amplitude, depending mainly on the periods needed for producing and using up their products. These subcycles are superimposed on each other, and the highest peaks are reached when their specific peaks coincide, the lowest troughs when their specific troughs coincide. We have experienced combinations of cyclical highs in the 1970s--so 1980-81 could turn out to be a major turning point.

The Inventory Cycle. One of these subcycles is the inventory cycle shown on Chart 2. It is based on the same kind of stock-flow relationship underlying Chart 1, combined with a multiplier equation and

adjusted to eliminate trend components. This chart was published in my book on Economic Forecasting and is explained in detail there; it is repeated here because it makes several points which are currently relevant.

1. It portrays the nature of forces in any real investment cycle. These appear as a succession of imbalances on two different levels, the level of stocks (I) and the level of flows (IIA), which produce swings in inventory investment (IIB). Correcting an imbalance on one level can only be done by creating an imbalance on the other, and this in turn subsequently creates another, opposite imbalance on the first. Currently, we are in a kind of transition; the downward adjustment of inventories in 1980 was trivial, so further liquidation must be expected.

2. The cycle of stocks (H) lags the cycle of final-sales flows (G) by about one quarter cycle. Suppose business wants to hold larger stocks (the increment i at t_1), possibly as protection against inflation. Output (O) must be increased over G and held there until the correction of H is accomplished at t_2. Then involuntary accumulation begins and must continue to t_3 when production is again brought into line with final sales. At such times there is distress borrowing, as is now in evidence in many firms, so stocks in the credit cycle also lag, and their growth is inflationary even though production and real income are falling.

3. On the downswing, the incentive to liquidate persists as long as there is an excess of H over rG+i, so that both stocks and flows decline to t_4. On the decline the depressing effect is potentially as strong as the expansionary effect was on the upside. From 1929 to 1933,

inventory liquidation increased in waves until at the low, its rate was almost twice the rate of accumulation in 1929.

4. In the trough, the movement overcarries just as it did at the peak, with involuntary liquidation continuing from t_4 to t_5. There was no significant accumulation from the fall of 1930 to the spring of 1933, merely some moderations in the rate of liquidation. To what extent inventories may be liquidated before inflation ends is today's question.

The Housing Cycle. Next consider a long subcycle. Data on residential building over a span of six decades are presented on Chart 3. I have elsewhere explained the housing cycle as a stock-flow relationship resulting in building fluctuations similar to those of level IIB of Chart 2 despite continued growth in households and houses. Here I want to tell a different story, emphasizing the variability of actual building activity. For this purpose, the cycles represented by the dashed lines are designed to match the actual data as closely as possible; they are ~~merely~~ empirical constructs without theoretical validity.

During the interwar period, there was just one major cycle, and with prices stable or drifting downward, the real cycle was dominant. The boom of the 1920s was followed by the depression of the 1930s. The long fall and recovery show a pattern of great regularity, uncontrolled and undisturbed until government intervention helped the recovery in the last 30s.

After World War II, the pattern was altogether different. There was hardly any trend in the 50s and 60s, as fluctuations conformed fairly well to a fixed cycle of 4.5 years duration, with highs at about 1.65 million units and lows at about 1.25 million units. This range of

about one-fourth of the cyclical highs was certainly significant but had little of the impact of the 90 percent decline from 1925 to the 1933 low. There was no major cycle of that kind in the postwar period. All through the 1950s and 1960s, building was aided by growth in the economy, by population mobility, by tax advantages, and recurrently by international disturbances. Whenever a decline occurred, government intervention sought to support the industry with easier terms, special financial arrangements, guarantees, budgetary contributions to low income units, and efforts to end racial discrimination.

In the 1970s, the pattern changed again. There were two great booms, rising above roughly the same annual cyclical lows. The first was set off by extremely large subsidies, which became a scandal because everybody in the building and real estate industries found ways to profit from them, so that low income families got very little of the benefit from a major government commitment. These subsidies were continued through 1972, and then, after reelection, President Nixon terminated them. The housing decline was then a major factor in the recession of 1974-75. But building soon revived. New subsidies were provided, inflation offered greater profit incentives, and the baby boom of the 1950s made its peak contribution in the market. Subsequently, record interest rates were important in the decline to the 1980-81 lows.

All of these postwar cycles were in one way or another artificial, none like the basic cycle of the interwar years. The question now is whether a more extreme and longer-lasting low is possible. Probabilities favor this because the adverse factors in the picture are very

important. Interest rates are still oppressively high, the demographics are sliding off into the low births of the 1960s, unemployment is high and likely to rise further, and unsold houses on the market are beginning to depress prices in many localities.

The Business Fixed Investment Cycle. Last of the real subcycles in this presentation concerns nonresidential fixed investment. Chart 4 was constructed in an effort to find an early indication of when a full investment recovery after each setback would get under way. For this purpose, the national accounts investment data are charted on a corresponding ratio scale with the index of industrial production. The latter is not entirely appropriate for this comparison because the investment series includes data for trade, services, and other, but the index serves anyway as a useful indicator of general economic activity.

The dashed lines are drawn from each high in production to the point where that high is recovered and then are dropped down to the investment series. Note that the big recoveries in the latter regularly take place after those dates. When production first starts to recover, the position of capital stocks is still unsatisfactory and puts a drag on investment.

What these data indicate is that the primary requirment for investment is a definite indication of growth in the economy. In comparison, such alternatives to growth as tax incentives and the availability of liquid funds are of lesser significance. Both of these had potential effects in the long upswing as well as recently. Tax changes left funds with business even when they made it appear that profits were lower. The corporations let liquidity decline to very low levels, but

without any real deficiency of investment in the 1970s. The revised Department of Commerce data show that investment averaged 16 percent of GNP in both 1948-72 and 1973-77 but rose to 17 percent in 1978-79.

In the recovery from the 1980 recession, in the euphoria of Reagan e the index of production approximately regained the earlier high by mid-1981. However, both production and investment were hampered by government efforts to control inflation, especially by unprecedented interest rates. In manufacturing, capacity failed to regain the 80 percent point, and a new recession got under way. As usual just after the peak of a boom, operating rates were falling and continued growth in capacity was adding to redundancy of capital stocks. (Remember, stocks necessarily lag in stock-flow cycles.) The only way to reduce surplus real stocks is to cut back production and wait until consumption and disinvestment bring them down. The more durable they are, the longer it takes, so that investment may in the early 1980s undergo a sharper and more prolonged decline than any other since World War II.

Despite a widely held belief, interest rates are not the whole problem, and a mere reversal of interest rate policy will not solve it. The cyclical forces are too powerful and the positions of businesses and consumers will be too much changed. The real threat is that deflationary policy combined with the decline in the real cycle will break the credit boom. Some of the mechanisms of this will be considered later; the effects of it may make subsequent reductions in interest rates futile, as in the 1930s.

The Transit Syndrome

The price ties that connect the real and credit cycles influence and are themselves influenced by developments in the two cycles. It

used to be taken for granted that price changes were part of the cycle, that prices would fall in recessions and rise in recoveries. In the 1970s, however, it appeared that the old relationships had broken down. Recessions could still slow the rate of advance somewhat, but the stickiness of prices and wages prevented declines. The result was summarized in the word stagflation.

One aspect of this arises in neither of the two cycles but in a great institutional change which has given corporations the ability to control the prices of their own products. The economic literature describing the trend toward concentration and the decline in price competition is voluminous. Oligopoly with administered pricing became the typical situation first in heavy, highly capitalized industries, where practices variously described as conscious parallelism or tacit collusion prevail, and conglomerate mergers have spread these so-called businesslike practices into other industries, services, and finance. They are now so pervasive it is hardly appropriate any more to speak of free market forces. It is no longer a question of whether prices will be controlled but only by whom and for whose benefit they will be controlled.

The control of prices under oligopoly depends on concerted action by a several powerful corporations that not only set prices but enforce them on the rest of the industry. An up-to-date example of this is General Motors and Ford's entering the rebate battle. They in effect said to Chrysler and American Motors, "You have been getting away with this price cutting long enough." But then prices were raised fast enough to make them high even after the rebates. So with some exceptions, such as the need to bring mavericks into line or to dump excess

inventories, the private power to raise prices is a substantial element in stagflation and during recessions in slumpflation.

Administered pricing in industry typically involves the addition of a desired percentage mark-up to average total costs at standard volume. In declines, the averaging of fixed costs on smaller volume tends to give prices an extra push. It may be pointed out that prices are supposed to be set on standard volume, not actual volume, so that this problem should be by-passed. However, producers under pressure do not operate on any principle. Even if some do, the averaging up of fixed costs takes place in the process of deciding what constitutes standard volume, since ideas of what the market will take on the average change as actual sales decline.

In the broader economy, recession now tends to initiate a generalization of what I call the transit syndrome. This disease of the local transit system progresses because raising controlled prices is thought to be a remedy for declining revenues. But it turns out to be fatal to many. Each increase in prices, each reduction in services, drives more passengers away, so revenues fall again, and the system degenerates as prices rise through successive stages to the point where it cannot survive without subsidies. Slumpflation is partly the mark of a similarly sick economy.

The power to raise prices even in recession--witness 1974-75 and 79-81--reverses the old relationship between price changes and unemployment. Instead of a trade-off, the two move together. With prices controlled upward, consumption is cut, output is restricted to match,

and the overall decline is reinforced. Without a basis in rising production, investment falls too, and the decline cumulates. An interesting sidelight on this element of downside instability appears in the requests for subsidies by steel, auto, and other industries in the form of protection against foreign competition, which operates by raising prices to domestic users.

The Credit Cycle

The impacts of inflation, and its dominant causes over the cycle as a whole, appear in the credit cycle, where prices and outputs are combined. One aspect of this cycle has been understood for many years, namely, the process by which the money stock is expanded as the banking system lends up to the limits of its reserve ratios. That process is at the heart of monetarist and most other discussions of inflation. But simply looking at rates of growth in some monetary aggregate, whether supply or demand determined, cannot give an adequate explanation of what happens in the double carrousel of Chart 1. The interactions of the stocks and flows produce changes in each, in part through shifting prices of assets, products, and interest rates, so that the determining factors on the state of the economy are much more complex.

One of the great contributions of Keynesian theory--the diverse roles of saving and investment--is being smothered in rationales aimed at justifying current economic policies. What Keynes wanted to explain was the experienced instability in the real world economy. In the mechanism of change he developed, the economy goes where investment goes and saving comes along, with the effect of limiting the movement.

At the cyclical peak, saving is a negative in the picture, and this still holds for saving generated in the income stream. He showed that an excessive propensity to save could lead to "less-than-full-employment equilibrium," not because he believed there was any such thing as equilibrium but to account for chronic unemployment. That condition in the 1920s and 30s in Great Britain has returned with aggravated effect there and in our own stagflation.

There are three means of financing by which saving is forced into equality with investment: if savings derived from income are inadequate, funds are provided by the banking system, possibly even in excess of the actual need; and if both of these are inadequate, the price system does the job by producing high business profits and high business savings. Both of the last two hold the potentials for inflation, the one general, the other specific to industries like oil, where market conditions or industry structure provide the opportunities. Both result in what used to be called "forced saving."

In any case, saving has been ample. The revised Department of Commerce data show that saving was higher than average in 1978-79, matching the high rate of investment. Yet it is proposed that "savings" should be made still higher.

In the early stages of upswings, prices and profits run ahead of wages, providing a margin for enlarged investment. This is further enlarged by credit expansion, which boosts monetary assets, and prices of real assets are for a while bid up above costs of reproduction. This adds to the incentives to invest that result from the more basic

acceleration in the real cycle. Later, as the cyclical peak is approached, the incentives to invest tend to be reversed and the accumulation of capacity imposes a growing drag, so that investment lags.

Attempting to cure this by artificial means, such as tax cuts biassed toward increasing savings, puts new life in the credit cycle, and the enhanced action in that cycle to some extent spills over into the real cycle. The effect on investment could be almost nil, depending upon how adverse the expensiveness of new investment was at the start. In any case, however, the real effect is temporary, for two reasons: first, prices are bid up further and the depreciation of the monetary stocks is aggravated to the extent that their stimulative power is lost; and second, a greater imbalance between the real capital stock and the flow of goods and services it is designed to support will develop, again putting the brake on new investment. These corrections take some time but in the end the whole effort becomes self-defeating.

What is new in the last decade is the great proliferation in the forms of money and credit. Almost any kind of deposit can serve as money on some definition of a monetary aggregate, and nonliquid assets are satisfactory if the returns or hoped-for-gains are adequate to compensate for the loss of liquidity. The accumulation slows when debt imposes a restraint on the spending ability of some and when others with swollen portfolios become satiated with the massive stocks of goods they have purchased to show their affluence.

The money stock accumulates, too, and when holdings become excessive, they have to be cut back, at least in value. The way to reduce surplus money holdings is in the first instance to buy other assets.

The funds realized by the sellers of those assets in turn move into the circular flow, expanded often by additional credit. In the search for additional earnings, the emphasis shifts toward speculative outlets. Even the corporations join this quest. Affluent industrial corporations that do not feel secure in prospects for expansion divert surplus savings from new investment into takeovers or mergers--witness the oil industry activities since 1973.

The Propensity to Speculate

The credit cycle takes on new life with speculation. In recent years the propensity to speculate with borrowed funds has grown and spread from the financial community to the public at large. The awareness of profit opportunities in risky ventures is increasingly acute. It goes beyond the great wave of stock market speculation in the late 1920s which did not penetrate much into the real economy and was itself killed in the crash. Opportunities for any kind of resumption of speculation were limited in the 1930s and 1940s but awareness of them grew in the long postwar prosperity and came to infect much of personal spending and investing in the 1970s.

There has been a veritable anti-thrift revolution. Housing was particularly favored by the tax advantages provided. For speculation by the owners of wealth, new games have appeared and expanded. Through futures, options, and other devices, anyone with money can gamble on stocks, on gold, on commodities, on real estate, on collectors' items, on foreign exchange or interest rates--on almost anything that might provide a gain. Success in speculation typically leads to pyramiding.

Increases in asset values or gains in customer accounts enlarge the credit base. In addition, many kinds of tax shelters and get-rich-quick schemes, sometimes fraudulent, have helped to attract some of the loose money looking for magnification.

The movement could hardly have reached the extreme experienced in the late 1970s without ample funding to feed the fires. It did receive such funding through official policies and the ingenuity of financial institutions in utilizing resources to maximum advantage. In both 1978 and 1979, the latest years without recessions, funds raised in U.S. credit markets by nonfinancial sectors amounted to almost $400 billion, huge increases even for our economy. The federal government took only about one-ninth of the $800 billion total, and the private sector took $700 billion. The two year increase in the GNP over the same period was $500 billion, and gross private domestic investment rose less than $100 billion. Clearly, the great increase in credit expansion was not needed to finance productive activities. Only a small part of it went to government spending and that part steadily declined from 1975 to 1979.

All the assistance to credit for speculation, each round of gains in a rising market, enlarges the credit cycle with "savings" that are not matched in the real cycle. Expanding savings artificially by such means as tax reduction has the same effect. It is particularly these "savings" that do not originate in the income stream, and the financial flows they generate, that are largely responsible for the inflation.

Unfortunately, we do not have any good measure of the spill-over from these funds into the real cycle, but the proportion is clearly

not large. In 1978-79 the multiplied increase in GNP was much smaller than the credit raised to begin with, and this leaves out of account realized capital gains without a credit counterpart. After taking out the effects of investment financed by saving and all the other multiplier effects, the portion that went into expansion of the GNP may be estimated at less than one-fourth of the total. The remaining three quarters plus, appearing only in the credit cycle, contributed to the bidding up of prices, especially asset prices, both real and financial, and thus to the depreciation of money. In other words, the effect of building up these other "savings" is to promote inflation much more than growth.

Both speculative orientation and cyclical effects are apparent in the changes in consumer installment credit. Chart 5 shows these changes along with changes in business inventories. Together they are the major components of the short cycle. Consumer credit soared in the 1970s. Its peak rate of change in 1973 was $25 billion, which far exceeded the previous high, and then it moved up to a $50 billion peak rate in 1978. This growth of anticipatory buying is speculative and destabilizing. In the 1980 recession, the combined decline of changes in consumer installment credit and business inventories was almost twice the decline in real GNP revalued to 1980 prices, even though liquidation of either did not reach a high rate.

Other factors in the 1980 quickie recession were housing and business fixed investment. All four of these factors were affected by the sharp rise and fall in interest rates. Other parts of the economy held firm, and considerable support was obtained from a strong rise in net

exports. What was seen there, therefore, was just another minor setback which could be dismissed as of little consequence unless worse was to come. Current indications are that a deeper recession is getting under way. The export balance has already turned down, and the high interest rate policy is still in a depressive phase.

I speak of the high interest rate policy with deliberate intent. That is the only kind of tight money policy we have had in this country. Even now plentiful funds are available for anything people may want to do. The main thing Chairman Volker of the Fed has done is turn the banks loose to charge whatever the traffic will bear. The banks welcome the opportunity to maximize their business at highest rates. They love having their own prices and incomes used as a means of restraining other people's prices and incomes. It puts into their own savings the greatest volume of funds for expanding the credit cycle at the expense of operators in the real cycle.

The high interest rates are themselves inflationary. They immediately boost costs of working capital; the announcement effects are positive for business decisions; the expectation of higher capital costs in the future creates a desire for increased cash flow immediately; and all these can be made effective quickly in prices. This is the third element in the financial community's contributions to inflation. The other two were the excessive expansion of monetary assets and the encouragement of the public to speculate, to borrow to buy now in order to beat the inflation ahead.

During the upswing of the late 1970s, the banks were reaching for business and were not greatly concerned about inflation, despite

pronouncements to the contrary, because it was the way to improve their own position. Now the situation is changing and the banks are coming to really need the inflation. It is needed because inflation validates the outstanding debt, first by protecting the equity of borrowers and making it easier for them to repay, and second, in the event that it is still necessary to foreclose, the rise in prices of collateral assets protects the principle.

An important potential weakness in the current picture is that the banks, like other intermediaries, are again threatened, as they were in 1930-31. Very few people realize what small margins they are operating on. Total assets of $1.5 trillion exceed liabilities by less than ten percent, and many of the assets are being carried at values far above current markets; they are illiquid and cannot be adequately drawn upon despite efforts to balance maturities against liabilities. A surge in defaults anywhere could initiate a spreading wave of interdependent bankruptcies. Financial prosperity becomes a fragile condition in the late stages of a long upswing.

The problem here is complicated and reinforced by conditions abroad, particularly in the face of mutual mistrust among nations. Much of the whole world's credit structure has become shaky through excessive expansion and inflation. Eurocurrency assets and debt have long been out of control. They total over $800 billion, of which about $650 billion are Eurodollars. Third World countries have been put in an almost impossible situation by the burden of fuel costs. Their debt to international banks is about $300 billion and has to be kept alive by refunding. The willingness of the debtor nations to refund at ever

higher interest rates is another form of distress borrowing, and there is no way to force payment if they default. A great slide into debt liquidation could start there.

The Frailty of Official Policy

The Fed and the Administration are looking with misplaced confidence across what they suppose to be the shallow valley of 1981 to greater heights in 1982-83. They focus on the fight against inflation, let consumer real income slide and unemployment rise, refuse to concede the potential of cumulative cyclical forces, and hope growth will reassert itself. Ignored is the danger inherent in the fact that the collapse of speculative booms has always been drastic--from the time of the Tulip Craze--and is not likely to be different this time.

The downturn in the credit cycle comes when saturation in the real cycle exposes the lack of substance underlying the huge credit build up. The real economy loses the desire to expand because it is already capable of producing more than is wanted by a population well stocked with goods and the services of facilities. Debt becomes increasingly shaky and financial assets lose their glamor when real growth loses its credibility. Attempts to gain liquidity, to reduce debt and shift out of questionable assets, stimulate distress borrowing and sustain the credit cycle briefly, but that brief lift only aggravates the insecurity of operators in the real cycle.

The Fed and the other controllers want to prevent the worst. They have been serving the special interests of the institutions under their jurisdiction, trying to keep them healthy. It is typical that they are

permissive too long and only react strongly in the late stages of a boom when speculation becomes rampant. In 1929, the Fed's tightening to curb the stock market was moderate and any effect it did have on the real cycle was accidental; the latter was itself laying the basis for the market collapse.

Monetarists generally follow Friedman's lead in blaming monetary policy for the Great Contraction but that thesis is not really tenable. Until Roosevelt's election, it was not a time of strong intervention in either monetary or fiscal policy. By the end of 1930, the high powered money that was the Fed's primary responsibility was down hardly at all and then rose, and the money stock was down only 6 percent. In contrast, housing starts were down about 60 percent, real industrial gross investment was down more than 30 percent, and the change in business inventories was negative by more than the peak rate of accumulation in 1929. The real cycle ruled the decline and the trough, aided from late 1930 by all kinds of bankruptcies, especially bank failures. This time the peak situation is different, and the Fed must bear a major share of the blame for a downturn beyond its ability to control. Certainly the recent Fed action is much more extreme than in 1929 and is fully premeditated. If it succeeds in ending inflation, the result will probably be disastrous.

Fiscal policy is hardly any help, being inconsistent to the point of irresponsibility. It is inflationary in its tax cutting and military spending, but deflationary in its budget cutting and contributions to unemployment; it seeks to promote high expectations for a rising

future, but destroys confidence in expanding federal deficits and insisting on austerity for the less affluent; it provides savings for investment but undermines the basis for real investment by restricting consumption at home and squeezing potential markets abroad. It appears that the commitment to full employment is gone, and nothing is planned to take its place. Struggling with a budget that is bound to get worse in recessions, the Administration cannot quickly, and certainly not adequately, shift to positive programs that might cushion a decline. Pushing the Fed to do the job by easing interest rates is not enough.

What is being demonstrated again is that political predictions and promises have little effect on the course of the private economy, whatever their rationale in contrived and oversimplified economic theories. If they temporarily get a favorable response, that state of mind is subject to change with any new development. Talk about mandates is as meaningless as jawboning for cooperation. Neither voting nor the ballyhoo that lines up votes can provide reasonable answers to technical questions. What matters are the realities of economic positions and opportunities, as related to the stages of business cycles.

From this analysis, it appears that the world faces a protracted period in which the real cycle is depressed but elements of inflation are always present. Rising unemployment, depressed construction, excess capacity, inventory liquidation, and falling foreign markets are important negatives in the real cycle. Wage contracts, other term obligations, the transit syndrome, exogenous factors, and compensatory government initiatives with rising deficits will tend to preserve the

inflation part of slumpflation. Since this combination represents the extremity of hard times for the people, there is no way to tell its ultimate effects on the socio-political structure.

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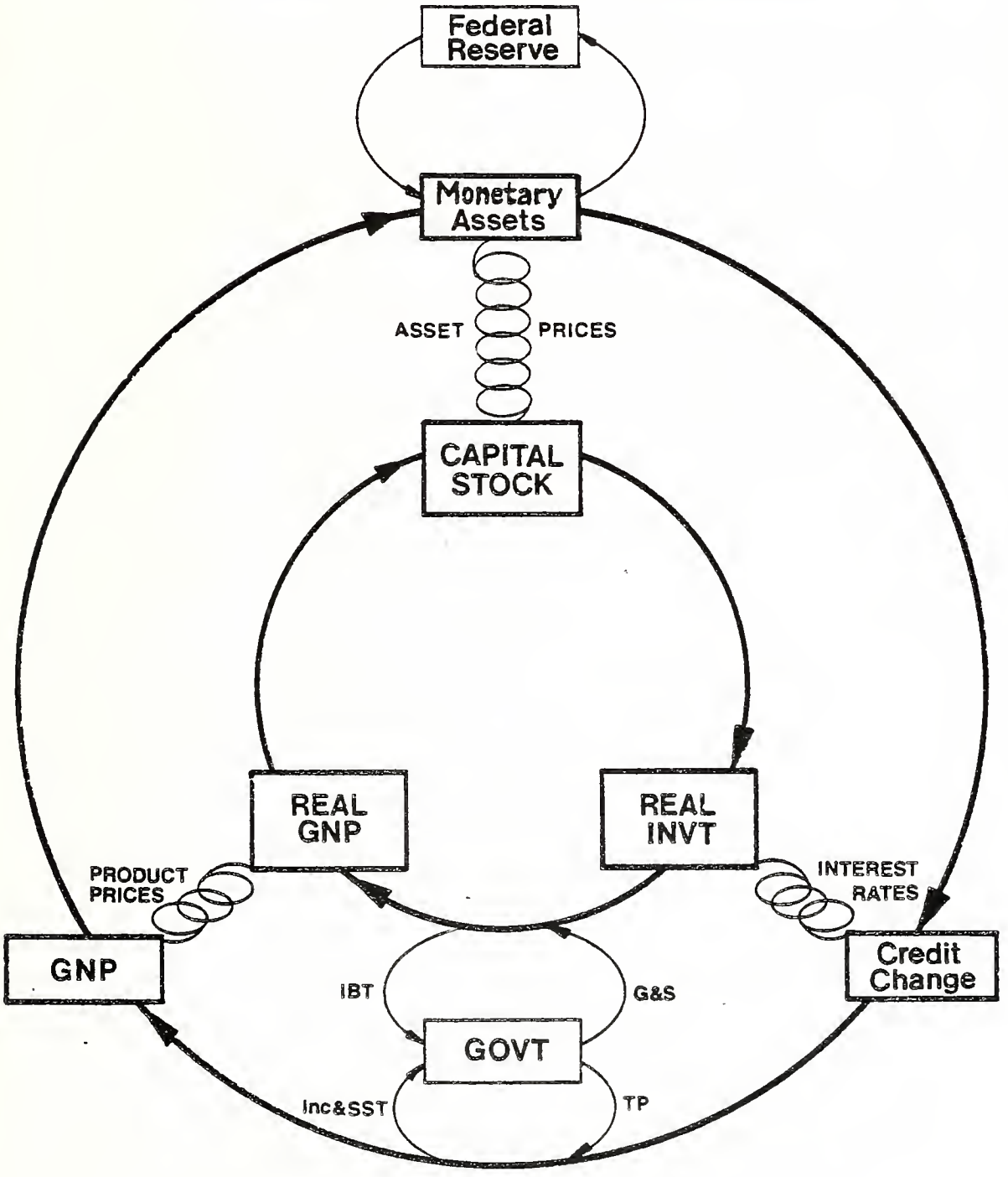
Chart 1. The Double Carrousel of Business Cycles



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THE INVENTORY CYCLE

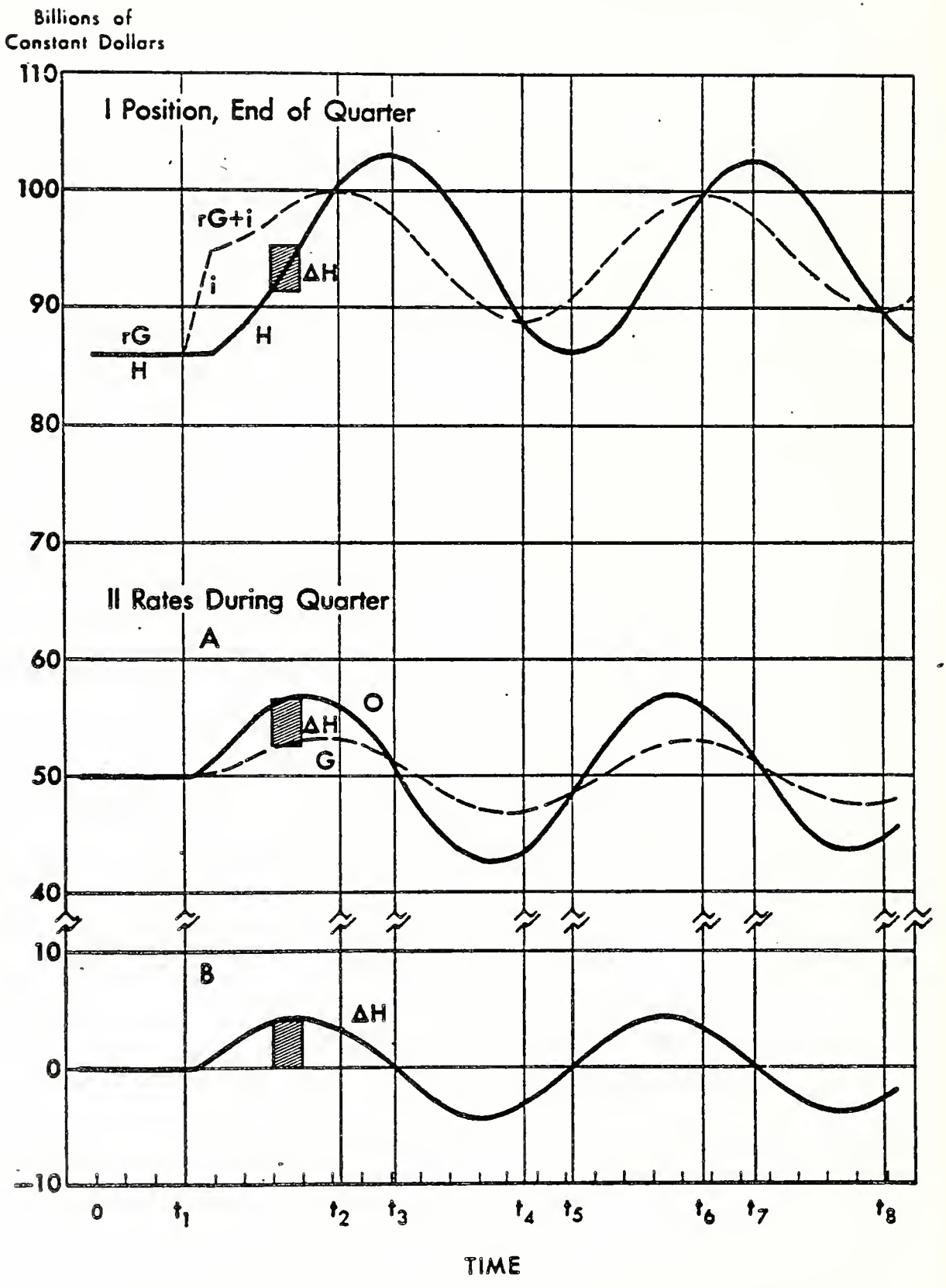

Chart 3. Cycles in Nonfarm Housing Starts, 1920-1980

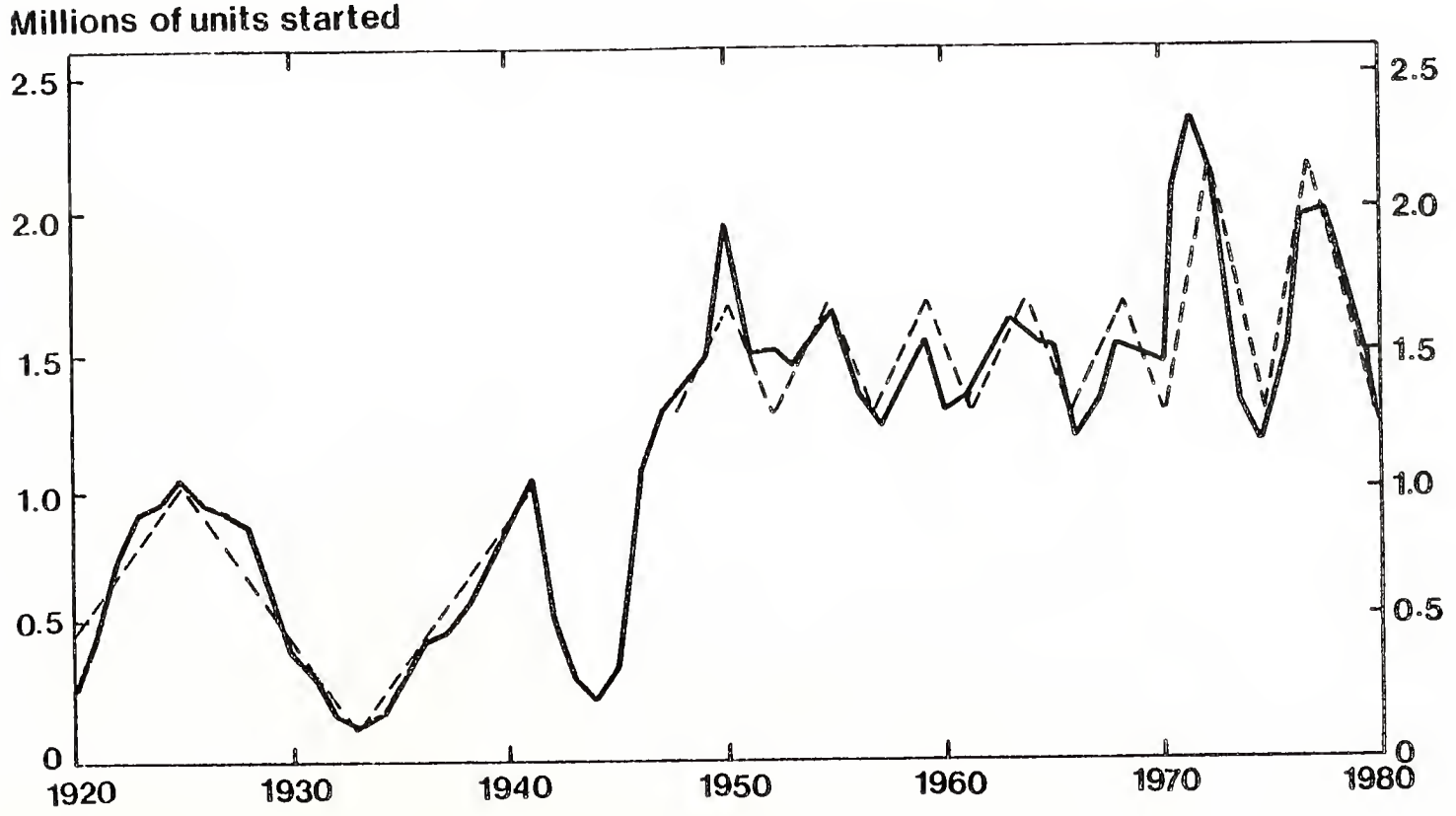

Chart 4. Recoveries in Industrial Production and Nonresidential Fixed Investment (ratio scales)

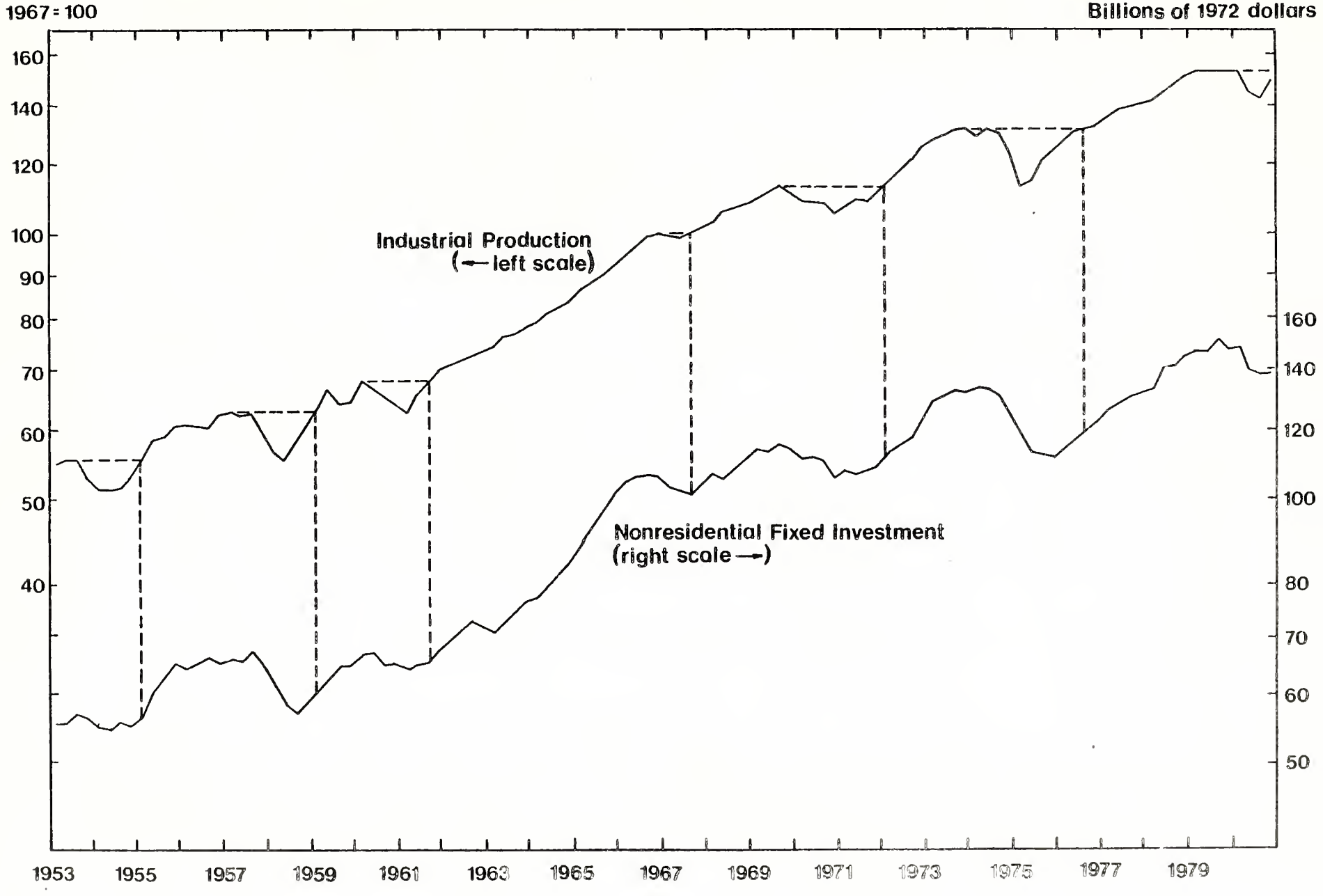

Chart 5. Changes in Business Inventories and Consumer Installment Credit